MINUTES
of the
FIRST MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

September 6, 2006
State Capitol
Santa Fe

The first meeting of the Investments and Pensions Oversight Committee for the 2006 interim was called to order by Representative John A. Heaton, chair, on Wednesday, September 6, 2006, at 10:00 a.m. at the State Capitol in Santa Fe.

Present
Rep. John A. Heaton, Chair
Sen. John Arthur Smith, Vice Chair
Rep. Miguel P. Garcia
Sen. Phil A. Griego
Rep. Larry A. Larranaga
Sen. Carroll H. Leavell
Rep. Luciano "Lucky" Varela

Absent
Rep. Donald E. Bratton
Sen. Joseph J. Carraro
Rep. Henry Kiki Saavedra

Advisory Members
Gary Bland, State Investment Council (SIC)
Frank Foy, Educational Retirement Board (ERB)
Robert Gish, Public Employees Retirement Association (PERA)
Rep. Patricia A. Lundstrom
Rep. Kathy A. McCoy
Olivia Padilla-Jackson, State Board of Finance
Sen. Leonard Lee Rawson
Rep. Joe M Stell

Sen. Pete Campos
Sen. Carlos R. Cisneros
Sen. Joseph A. Fidel
Rep. Justine Fox-Young
Sen. Stuart Ingle
Sen. H. Diane Snyder

Staff
David Abbey, Legislative Finance Committee (LFC)
Michelle Bell, LFC
Doris Faust, Legislative Council Service (LCS)
Cleo Griffith, LCS
Larry Matlock, LCS
Norton Francis, LFC
Doug Williams, LCS

Guests
The guest list is in the meeting file.

Wednesday, September 6

Olivia Padilla-Jackson recommended that the committee receive a status report from the Governor's Ethics Reform Task Force at a future meeting.

Representative Larranaga recommended that the committee examine the structure of the retirement benefits paid by PERA and ERB.

Representative Varela recommended that the committee examine the composition of the ERB.

Senator Smith noted that the legislature has been attempting to restructure the ERB membership for the past two years. He recommended that the committee build a consensus during the interim.

Representative Heaton requested that Evalynne Hunemuller, executive director, ERB, bring the appropriate parties to the table to discuss the structure of the ERB.

Summary of Fiscal Year 2006 Investment Performance

-Gary Bland, State Investment Officer
-Frank Foy, Educational Retirement Investment Officer
-Bob Gish, Public Employees Retirement Investment Officer

Mr. Foy reported on the performance of the ERB as summarized in the following table:

Performance Summary

	1 Year Ending 6/30/06	3 Years Ending 6/30/06	5 Years Ending 6/30/06	10 Years Ending 6/30/06
Policy Index	10.7%	12.4%	6.2%	8.4%
Actual Earnings				
Total Fund	12.3%	12.5%	5.9%	7.9%
Total US Equity	10.2%	12.3%	3.3%	8.7%
Large Cap Equity	9.3%	11.2%	2.1%	NA
Small Cap Equity	15.3%	18.7%	7.7%	NA
International Equity	29.1%	24.7%	11.0%	NA
Total Fixed Income	0.7%	2.5%	5.4%	6.8%
Real Estate	21.9%	NA	NA	NA
Cash	4.9%	2.9%	2.7%	NA

Mr. Foy noted that since the passage of the Prudent Investor Act in 2005, the ERB has engaged a private equity fund manager and is in the process of selecting a hedge fund manager. The ERB has authorized allocating five percent of assets to each of the following alternative investments: private equity, real estate and hedge funds.

Representative McCoy asked about the criteria used to select a money manager. Mr. Foy responded that the ERB examines the performance histories of potential managers and how well they adhere to their stated investment strategies.

Representative Larranaga asked about the process for selecting a hedge fund manager. Mr. Foy responded that the process is identical to the request for proposal (RFP) process used for traditional fund managers. There were 62 responses to the RFP, of which 22 were eliminated because they did not meet minimum requirements. Of the remaining 40, five finalists have been identified. Mr. Foy noted that the ERB will refer to hedge funds as an "absolute return" portfolio. Representative Larranaga asked if there was a last minute addition to the list of five finalists. Mr. Foy said all of the finalists were identified through the regular procurement process.

Representative Varela asked about the status of real estate investments. Mr. Foy indicated that an RFP for a real estate fund manager will be forthcoming in the next two to four months.

Representative Heaton requested that the ERB present a preliminary actuarial report at the next meeting of the committee.

Mr. Gish reported on the PERA investment performance. The results for fiscal year 2006 are summarized in the following table:

Performance Summary

	1 Year Ending 6/30/06	3 Years Ending 6/30/06	5 Years Ending 6/30/06	10 Years Ending 6/30/06
Policy Index	11.74%	12.36%	7.58%	8.28%
Actual Earnings				
Total Fund	11.74%	12.35%	7.58%	9.90%
Total US Equity	11.01%	13.63%	5.58%	10.52%
Large Cap Equity	9.49%	12.36%	3.83%	8.83%
Small Cap Equity	15.32%	17.68%	10.54%	12.73%
International Equity	30.26%	25.75%	11.04%	11.54%
Total Fixed Income	0.02%	2.89%	5.30%	6.54%
Cash	4.46%	7.97%	6.57%	6.00%

Historically, PERA's best performance year was 2004. PERA was in the first percentile of similar large retirement funds. Relative standing has slipped to the twenty-second percentile because PERA was required to invest in accordance with a legal list. With the passage of the Prudent Investor Act, PERA believes that its relative standing will improve.

Representative Lundstrom asked if the alternative investments will help cover past shortfalls in investment performance. Mr. Gish responded that alternative investments alone are unlikely to cover shortfalls in the past, but will help in future market downturns.

Mr. Gish noted that last year PERA paid out $90 million more in benefits and other expenses than were received in contributions.

Representative Larranaga asked about the PERA policy with respect to hedge funds. Mr. Gish said that the PERA Board has authorized five percent of its assets to be allocated to hedge funds. Also, five percent of assets may be allocated to real estate and five percent to private equity investments. PERA has not yet selected any alternative fund managers or made any alternative investments.

It was noted that, overall, PERA is 93 percent funded. Representative Varela asked about the Volunteer Firefighters Fund and Terry Slattery, executive director, PERA, responded that the fund is more than 100 percent funded; however, it is very difficult to know the true liability because fire chiefs have not been good at reporting on active membership.

Representative Varela asked about the deferred compensation plan and requested that, at a future meeting, the committee receive a report from Nationwide regarding the plan. Mr. Slattery noted that Nationwide has five in-state representatives who held approximately 600 meetings with plan participants last year.

Mr. Bland reported on the SIC's performance in fiscal year 2006. He noted the following.

- For the 12 months ending June 30, 2006, the combined funds experienced a net investment gain of $1.5 billion, easily outpacing the $312.6 million in net distributions. The combined funds recorded a net investment loss of $44.9 million for the quarter. Total assets declined from $13.7 billion at the beginning of the quarter to $13.6 billion at the quarter's end, with $23.9 million in net distributions.

- For the five-year period, the Land Grant Permanent Fund (LGPF) returned 5.7 percent, exceeding its policy index by 0.2 percent. Over the same period, the Severance Tax Permanent Fund (STPF) lagged its policy by 0.4 percent, with a return of 5.4 percent.

- For the year, the LGPF returned 10.6 percent, exceeding its policy index by 0.8 percent, while the STPF trailed its policy by 0.1 percent with a return of 11.2 percent. Both funds surpassed their respective benchmarks for the quarter. LGPF returned -0.2 percent versus its policy return of -0.7 percent, and STPF returned -0.3 percent versus its policy return of -0.7 percent.

- Total equity exposures for the LGPF were 61.2 percent. The STPF's equity exposure was 60.5 percent, with a structural overweight to fixed income, while the private equity program is still being developed. All allocations are within policy limits.

Mr. Bland noted that, for those investments managed internally, the cost per trade is approximately two cents per share, which is significantly below the industry average. The total cost of managing the internal investments is five basis points.

Senator Rawson observed that SIC is underperforming ERB and PERA. He noted that the retirement funds have a large and growing liability, while SIC has a known liability fixed in law. He suggested that this situation would allow SIC to be more aggressive and earn higher returns than ERB or PERA. Mr. Bland observed that the SIC Board has adopted a conservative investment policy because: (a) the SIC has a known payout but an unknown income stream; and (b) SIC is guarding against repeating the losses experienced in 2001-2003.

Representative Larranaga noted that the legislature should be allowing more severance tax revenue to flow to the permanent fund.

Legislative Finance Committee Report of Investment Performance

-Norton Francis, LFC

Mr. Francis presented a combined report jointly prepared with the Department of Finance and Administration that summarizes the performance of the SIC, PERA and ERB. He noted that in the one-year period ending June 30, 2006, investment returns finished positive, despite giving up gains to a disappointing fourth quarter. ERB posted the highest return at 12.3 percent, followed by PERA at 11.74 percent; both funds beat their one-year benchmarks by 1.6 percent and 1.9 percent respectively. The STPF gained 11.2 percent for the year but trailed its policy target by 0.1 percent, while the LGPF returned 10.6 percent, beating its policy target by 0.8 percent.

For the five years ending June 30, 2006, PERA lead with the highest return at 7.58 percent, which beat its fund benchmark return of 6.12 percent by an impressive 1.5 percent. The ERB had the next highest return at 5.9 percent, but missed its target by 0.3 percent. The LGPF's return of 5.7 percent outperformed its target of 5.5 percent by 0.2 percent, and the STPF finished at 5.4 percent, missing its target by 0.4 percent. All the investment funds surpassed the five-year 60/40 index, which returned 3.8 percent.

Representative Stell asked how the $40 million in the Water Trust Fund has come to be managed by the SIC even before the referendum. Ms. Padilla-Jackson responded that the $40 million was a general fund appropriation, not bond proceeds requiring approval of a referendum by the voters, and it was appropriated to the New Mexico Finance Authority (NMFA) for use by the Water Trust Fund. The NMFA does not engage in long-term investments and, therefore, SIC manages the assets for the NMFA.

Representative Larranaga requested a report on the SIC film investments at a future meeting.

Status of State Treasurer Financial Operations

-Douglas Brown, State Treasurer

Mr. Brown presented a report on the status of the State Treasurer's Office. He noted that, in November 2005, the State Treasurer's Office had more than 5,000 deposits worth $160 million that were not reconciled; had minimal investment procedures/transactions disclosure or transparency; was an unstructured agency with little accountability or checks and balances, where building and computer security were compromised; and had unqualified people in key agency positions.

Improvements have been made in both office administration and investment procedures, notably:

- accounts reconciliation is 100 percent complete through June 30, 2006;
- the agency has been restructured with more accountability;
- building and computers are secured;
- necessary personnel changes have been made;
- a compliance officer has been added;
- new internal policies have been implemented, including:
    - code of conduct;
    - campaign contributions prohibitions; and
    - whistleblower procedures;
- the investment policy has been improved with over 300 revisions;
- the electronic trading platform has lowered commissions by over 50 percent;
- more competition and transparency on investment trades;
- full disclosure of all investment transactions;
- open meetings of State Treasurer's Investment Committee;
- an expanded broker/dealer list;
- New MexiGROW LGIP AAAm rated by S&P;
- New MexiGROW LGIP yield - 3.2 percent in 2005, 5.2 percent currently; and
- the General Fund shows monthly earnings of $5 million in January 2006 and $12 million in July 2006.

Mr. Brown noted that to improve accountability of the state treasurer, he is recommending that the state treasurer be an appointed position. The state treasurer might be appointed by the legislature. This would make removal from office much easier than the impeachment process.

New Mexico now has a AAA Local Government Investment Pool rating from Standard & Poors and is one of only 12 states to have such a rating.

Mr. Gish asked about past audit exceptions. Mr. Brown said that, in fiscal year 2004, there were no exceptions and that, in 2005, there were 16 exceptions. Mr. Brown noted that two or three exceptions is the most that there should ever be.

Hedging of Oil and Gas

-Olivia Padilla-Jackson, Director, State Board of Finance

-David Paul, Financial Strategies Group, Inc.
-David Buchholtz, Brownstein, Hyatt & Farber, P.C.
-Jaimie Scranton, UBS Securities, L.L.C.
-Chris Brown, UBS Securities, L.L.C.

Ms. Padilla-Jackson introduced a presentation on hedging oil and gas prices. Representatives of UBS Securities, L.L.C. (UBS) noted that New Mexico budget revenue could fluctuate significantly with market prices; however, using risk management tools to "lock in forward energy prices" can reduce volatility in budget revenue and that current market prices provide an opportunity to lock in prices above the budgeted prices. Locking in commodity revenues will:

- generate significant excess budgetary revenues for the state;
- limit exposure to falling gas prices; and
- provide a guaranteed revenue stream for the General Fund or Severance Tax Bonding Fund.

Excess revenues could be appropriated for the fiscal year to programs such as:

- school funding;
- water needs;
- local transportation needs;
- alternative energy funding;
- transportation revolving funds; and
- economic development.

However, no funding source is without risk. While providing budgetary financial certainty for a portion of oil and gas revenues above current estimates, if gas prices spike over the swap term, the state would not capture full benefit of these price increases.

Risk may be reduced through three market instruments: a swap, floor or collar. A swap locks in a guaranteed revenue stream for the state prior to the fiscal year start, which allows:

- excess budgetary revenues to be spent in the current fiscal year;
- funds to flow into the General Fund to be used for various purposes; and
- the cost of the swap to be included in the pricing of the transaction and not be paid up-front.

The state can execute a floor to minimize its exposure to commodity prices below budgeted levels. While a floor eliminates downside risk, it would also allow the state to participate in the full extent of any spikes in commodity prices; however, the state would pay an up-front fee to receive the protection of the floor. A floor would not provide budgeting certainty to the state; therefore, it could not budget for increased revenue receipts prior to actual receipt.

A collar establishes a band of prices within which prices can fluctuate with no payments by either party. While a collar provides greater budget certainty than remaining fully exposed to commodity price, it would not allow the state to pre-establish a price. Therefore, it would not allow for revenue increases versus budget and may only be available for a narrow band on a costless basis, depending on market rates.

The following table outlines the advantages and disadvantages of each financial instrument.

Instrument	Advantages	Disadvantages
Swaps	"Locks In" Budget	No Participation in High-Price Environment
	No Up-Front Premium	Possible Margin Requirement
Floor	Protects Budget in Low-Price Environment	Significant "Up-Front" Cost
	Retains "Upside" in High-Price Environment	No Margin Requirement
Collar	Lower "Up-Front" Cost; Some Participation in High-Price Environment	Less "Up-Front" Cost
	Takes Advantage of Asymmetrical Price Volatility Curve	Possible Margin Requirement

The largest risks to the state in locking in commodity prices are:

- price risk - the risk that prices increase above swap levels, therefore limiting New Mexico's ability to participate in higher market levels;
- basis risk - the risk that New Mexico's commodity prices and the locked prices do not correlate;
- production risk - the risk that New Mexico's level of commodity production will be above or below the amount locked in; and
- counterparty risk - the risk that the entity facing the state on the transaction did not perform on the trade.

UBS has reviewed the state's production and sales/pricing data and compared it to market data. UBS believes that given a historic statistical analysis, the state can effectively mitigate the majority of these risks through a customized swap program.

Mr. Buchholtz stated that legislation would be required to permit the state to move forward with hedging of oil and gas prices.

Representative Varela asked if the UBS revenue estimates have been examined by the state economist. Ms. Padilla-Jackson stated that the estimates have not yet been reviewed; however, she would be pleased to have them reviewed and have the state economist report to the committee.

Representative Heaton invited the group to return at the committee's final meeting to present proposed legislation.

Mr. Abbey suggested that any hedging be based on Henry Hubb prices not Permian Basin prices in order to eliminate basis manipulation.

Retiree Health Care Authority (RHCA) - GASB Rule 45

-Marie Thames, Executive Director, RHCA

Ms. Thames explained that Government Accounting Standard Board (GASB) Rule 45 requires that the RHCA publish any unfunded liability in its annual report.

RHCA has hired an actuarial firm, and it is currently working on the issue of complying with GASB 45. A very preliminary estimate is that RHCA may have a $1 billion unfunded liability. Also, at present, it is projected that the unfunded liability might be retired over the next 25 years.

GASB 45 also requires that the future flow of funds may not be used by actuaries in calculating an unfunded liability unless the corpus of the fund is held as an irrevocable trust.

Representative Varela asked about the penalty for not complying with GASB 45. Ms. Thames indicated that failure to comply could result in a lower bond rating for the state.

Ms. Griffith suggested that the RHCA return to the committee at a future meeting with proposed legislation.

Work Plan and Meeting Schedule Development

-Doug Williams, Researcher, LCS

The committee approved the proposed work plan and chose future meeting dates as follows.

October 16-17, 2006
November 6, 2006
December 20, 2006

Committee Discussion of October Agenda

The committee decided that it wants the following items addressed at future meetings:

- conflict of interest;
- composition of the boards of PERA, SIC and ERB;
- status of the Water Fund Trust;
- deferred compensation;
- NMFA investments;

- review of retirement benefits;
- list of special funds;
- recommendations of the Governor's Ethics Reform Task Force; and
- proposed changes in retirement benefits.

Other Business

There was no other business brought before the committee.

The committee adjourned at 4:15 pm.